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The Development of Stock Markets in China

In December 1990, the Shanghai Securities Exchange, China's first recognized stock exchange, officially opened; a few months later, in April 1991, the Shenzhen Stock Exchange opened. Since then, equity prices in these emerging markets have taken a roller coaster ride. For example, at the end of 1991, Shanghai Fello Shareholding Co., Ltd., had a price/earnings ratio of 538.7 and was considered the most overpriced stock in the world; then, in mid-1993, the stock markets started to spiral down, and by July 1994, some indices had lost about 70 percent of their value.

In this *Weekly Letter,* we examine the performance of Chinese securities markets and their development. In moving from a centrally planned, state-owned economy to private ownership of economic resources, Chinese policymakers clearly face challenges as they strive to build their financial markets and evolve the appropriate institutions. These challenges often involve complex links among foreign investment, regulation, commercial banking, and securities markets.

The Chinese stock markets: background

After the exchanges opened on an experimental basis, the government established the China Securities Regulatory Commission in 1992 to regulate and supervise them. Only a very small fraction (less than 1 percent in 1991) of the enterprises that have converted to shareholding companies are listed on one of the exchanges. Firms chosen to be listed in these two exchanges have to show at least two years of satisfactory profit before getting listed. As a result, companies seeking to list on one of the exchanges may have to wait a few years. During this period, illegal black markets often emerge for trading shares of these unlisted companies. These black markets typically disappear when the shareholding companies get their stocks listed in the stock exchanges.

The process of privatizing the government-owned enterprises and start-up firms requires that they be established as shareholding companies (sometimes referred to as joint-stock companies). Shares in these firms are sold to public investors, employees, legal entities (other firms) and the government. Typically, the shares held by legal entities and government represent more than 50 percent of the total stock capitalization. This provides a mechanism for the government to retain control in the process of liberalizing and privatizing the financial sector of industry.

Currently, only shares held by individuals may be be traded on stock exchanges. Government shares are neither tradable nor transferable. Legal shares can be traded among enterprises themselves only and some of them are officially traded through two electronic trading systems (NET or STAQ) administered by the China Securities Trading System Co., Ltd. (CSTS). Initially foreign investors were excluded from owning shares in the Chinese shareholding companies. Trading in individual shares was limited to Chinese citizens; these shares have been referred to as A-shares. A second class of shares, B-shares, was created in February 1992 exclusively for foreign investors; B-shares are a vehicle to attract foreign capital and to facilitate transfers of technology and management skills to Chinese enterprises. Unlike A-shares that trade only in the Chinese currency Renminbi or yuan, B-shares are traded in U.S. dollars on the Shanghai Securities Exchange and in Hong Kong dollars on the Shenzhen Stock Exchange.

The volatility of Chinese stock markets

Figures 1 and 2 show the monthly A-share and B-share index movements from 1992 to 1994. When the stock markets first developed, the tremendous buying pressure from speculative investors caused market prices to skyrocket, while the

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number of individual investors registered with the Shanghai Securities Exchange increased from 30,000 in 1991 to 4.6 million in 1993. Some have suggested that the high prices and surge in participation reflected investors' belief that stocks would be very stable and would continue to rise in price because the Chinese government generally holds at least 50 percent of companies' shares.

Then, the stock markets started to spiral down in mid-1993. For example, the Shanghai Composite Index started at 364.7 in February in 1992, peaked at 1,358 in April 1993, and dropped to 334 by July 1994—a loss of about 75 percent of its value compared to its peak. The Shenzhen Composite Index dropped nearly the same proportion—about 72 percent from its peak. The high level of volatility caused many investors to become wary about this market and move their money to safer investment avenues, such as bank deposits and state bonds. A *Wall Street Journal* article (July 22, 1994) reported that individual savings at China's state-run banks increased by 40 percent in the first half of this year, even though interest on deposits was only half the 20 percent national inflation rate.

As Figures 1 and 2 illustrate, A-shares have been much more volatile than B-shares, and, for the most part, A-shares have been valued far above B-shares; for a time they moved closer together, but since August 1994, they have once again moved far apart. One explanation suggested for the lower volatility of B-shares is that they are allocated to foreign investors, who are argued to have more experience, since they typically have capital invested in more developed markets. Additionally, B-shares are traded in hard currencies, like Hong Kong dollars and U.S. dollars; since A-shares are traded in RMB, many investors fear they might depreciate in value due to the high inflation in China.

Figure 1
Shanghai Exchange

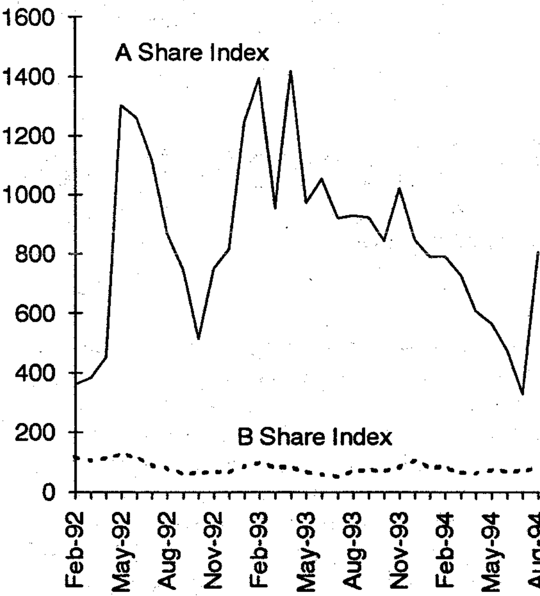
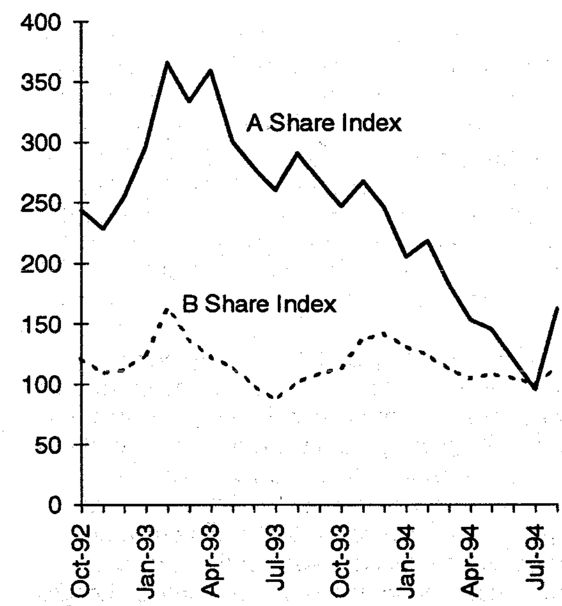


Figure 2
Shenzhen Stock Exchange



Regulatory restrictions on the development of securities markets

The complexity and lack of comprehensive policies related to a number of securities markets institutions have added to the uncertainty in the securities market. Specifically, these policies are related to the (a) convertibility of the Chinese currency, (b) segmented foreign ownership of stock, (c) the role of banks in financing the securities markets, and (d) changes in the institutional features of the market.

The effect of nonconvertibility and segmentation of shareholders on stock market uncertainty can be seen in the development of A-shares and B-shares. These are effectively identical claims on the assets of the firm, yet they are traded in different currencies and are held by different market investors. The existence of B-shares indicates that authorities find it desirable to attract foreign investment. However, the method of achieving this has led to a segmented market, where the A-shares are much more volatile than the B-shares.

A recent study by Mok and Cheung (1994) provides empirical support for market segmentation in that they find no direct evidence of long-run or short-run relationships between the A-share and

B-share markets. They find evidence that A-share prices incorporate news faster than do B-share counterparts. They suggest that this may reflect differences in market settlement procedures the two markets use. An alternative explanation involves differences in each market's investors. The *Securities Market Herald* (issue 2-3 1994) notes that in February 1994, the average number of shares per transaction was 773 for A-shares and 17,330 for B-shares. This evidence may be taken to reflect one market for small investors and one market for larger investors. Studies of initial public offerings in other markets often suggest that small investors frequently have lower quality information than larger investors. The pricing of A-shares relative to B-shares also may reflect the fact that Chinese investors have more limited investment alternatives than do foreign investors. For example, to the extent that Chinese citizens face lower yielding alternatives, the price of A-shares would tend to be bid up relative to B-shares. Thus, while foreign investment is desired in China, the mechanism for achieving it while still limiting its influence leads to a market where two identical claims on the firms assets (shares) can trade at different prices.

Additional complications exist related to the reform of the banking system. The role of bank credit in a developing market economy cannot be overstated. In China, banks lend to businesses to finance their operations. However, since the businesses also can trade in each other's shares, the government became concerned that many bank loans might be used for speculative purposes. Some firms borrowed money from banks to pay dividends despite poor earnings; as a result, they had high price/earnings ratios. Concern over this behavior and the speculative fever it helped create led to a prohibition against banks extending credit to participants in securities markets. The contraction of credit to finance purchases also resulted in higher market uncertainty and accentuated the price decline.

More recent uncertainties injected into the market relate to rumors of combining of A-shares and B-shares and unifying legal, government, and individual shares. B-share markets tend to respond more positively to these possibilities, since such changes may increase their access to markets with higher liquidity. However, as the Chinese currency RMB is still not freely convertible, the uncertainties associated with the feasibility of this unification leave investors' sentiment unpredictable.

Also contributing to volatility in these markets are rumors related to a possible policy change that would allow legal and government shares to be listed and traded together with the individual shares. Investors feared this would create a huge supply of shares in the market and exert downward price pressure. This is evidence that investing decisions in the A-share market are not based on the earnings potential of the companies themselves.

China differs from most countries with developed securities markets in that regulators and other government agencies select firms that can list various types of shares on the markets. Initially, the government planned a rapid increase in the listing of new companies. However news of this led to fear that the supply of new shares would tap capital from existing markets and cause a decline in share prices. The recent government announcement of banning all new issues and listings for the rest of the year resulted in a record high volume in August 1994. Overall, this evidence suggests that uncertainty and changing government policy have contributed to the level of stock market volatility.

Conclusions

Judging from the current market conditions, it may take some time before the stock markets in China reach the stage of mature and efficient markets. The high volatility in these markets can be traced at least partly to uncertain regulatory policy. Even though many securities laws have been developed since the China Securities Regulatory Commission was established in 1992, many still are evolving and are subject to sudden change. Until a more comprehensive Securities Act is released and investors are trading in a more certain environment, high volatility in the stock markets seems to be inevitable. The case of China provides a useful illustration of the need for securities regulation and the impact of interdependencies between policies related to foreign investment, commercial banking, monetary policy, and securities markets.

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